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cutting through complexity

NAREDCO

Funding the vision

‘Housing for all by 2022’

Banking conclave

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Foreword

Availability of adequate liquidity is a major requirement for the smooth growth of the real estate sector in India. However, the real estate sector is largely depended on funding households, which provides about three-fourth of total investment in the real estate sector. In the last couple of years, household investment in the real estate sector has decreased owing to rising property prices and high interest rates. Meanwhile, the equity capital which started flowing in after the relaxation in 2005 has completely dried up after the global financial crisis in 2009. Institutional lending has grown at a tremendous rate, and this has largely filled the gap created by the slowdown in investments by households, and the private capital. Over the last six to seven years, the government's participation has remained stagnant at merely three per cent of the total investment in the real estate sector. Much of the government's investment seems to be channelised towards rural housing development.

In light of the government's vision to provide housing for all by 2022, it is imperative that sufficient reforms are introduced in the short-term to improve availability of funding in the sector. These are urgently required as a real estate project cycle is about seven to eight years, and any actions taken now would ideally reflect after few years. Reforms such as encouraging PPP, granting infrastructure status, setting up a housing fund, increasing ECBs' limit, improving mortgage debt and capital market penetration, and overall allocating higher funding towards the real estate sector are few reforms which are overdue.

Another major issue in the real estate sector, which has increased risk affecting the availability of liquidity is the widening of the real estate project life cycle. A project today takes anywhere between seven to eight years, of which about 20 to 30 per cent of the capital investment happens in the initial years. Liquidity from formal channels is available only for four to five years, and that too at the start of construction. Thus, the lack of long-term capital in the sector could be restricting entry of new players into the market.

The study, conducted in conjunction with one of the apex bodies representing the Indian real estate sector, NAREDCO, hopes to provide insights into the current funding mechanism in the Indian real estate sector, attain a perspective on the existing funding channels, discuss some of the major issues faced by both developers and institutional lenders, and make a few suggestions to address the current challenges. I would like to thank all the stakeholders involved in preparing this study.

Neeraj Bansal

Head - Real Estate and Construction

KPMG in India

Foreword

Banking and the financial system of India are expected to play a vital role in providing housing to all by 2022. Therefore, the real estate sector is looking for certain reforms from the Reserve Bank of India (RBI) to meet a total requirement of nine crore houses, and investment of at least USD2 trillion by 2022, as per KPMG study.

The RBI's recent notification allowing banks to raise long-term funds to finance affordable housing and infrastructure projects, and reducing the Statutory Liquidity Ratio (SLR) by 50 basis points, thereby allowing bankers to get more funds to lend, are a few positive steps.

Many more initiatives are expected from the RBI in the future, especially for the real estate sector which are expected to bring a smile to every developer's face, and allows him to focus on creating more housing rather than chasing banks/institutions for money.

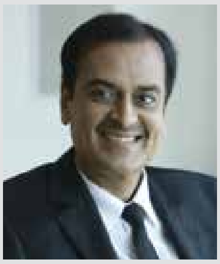
The real estate sector, one of the largest employer in India has received the least amount of money from the banking sector; less than 4 per cent of total advances, hence the developer community has to depend on alternate sources of funding which quite expensive and short-term in nature.

The banking conclave is expected to focus on how this total advances from the banking sector can be raised in the commercial real estate and initiate a slew of alternative mechanisms, as well as explore increase in home loans advances of the total banking exposure which has the least amount of NPAs and a strong asset base where traditionally defaults are bare minimum.

New mechanisms as such as External Commercial Borrowings (ECBs), which currently the RBI has allowed for USD1 billion, needs to be raised to USD10 billion. Borrowing money through the ECB mechanism for real estate projects must be given permission at the earliest.

Unless and until massive support from the banking sector in terms of finance is provided, the sector may not grow to the attainable level of 20 to 25 per cent annually, and realise the government's dream of achieving eight per cent GDP growth by 2017. Currently, the real estate sector contributes around 6 per cent to India GDP, and we expect this share to be increased to 10 to 2 per cent of the GDP share by 2022. This growth in the real estate industry is also expected to boost 250 other ancillary businesses dependent on it, thus, helping the overall growth of the economy.

This study, a joint initiative by NAREDCO and KPMG in India showcases the steps required to provide funding to the liquidity crunched real estate sector. We are thankful to KPMG for the necessary support and guidance for preparing this study.



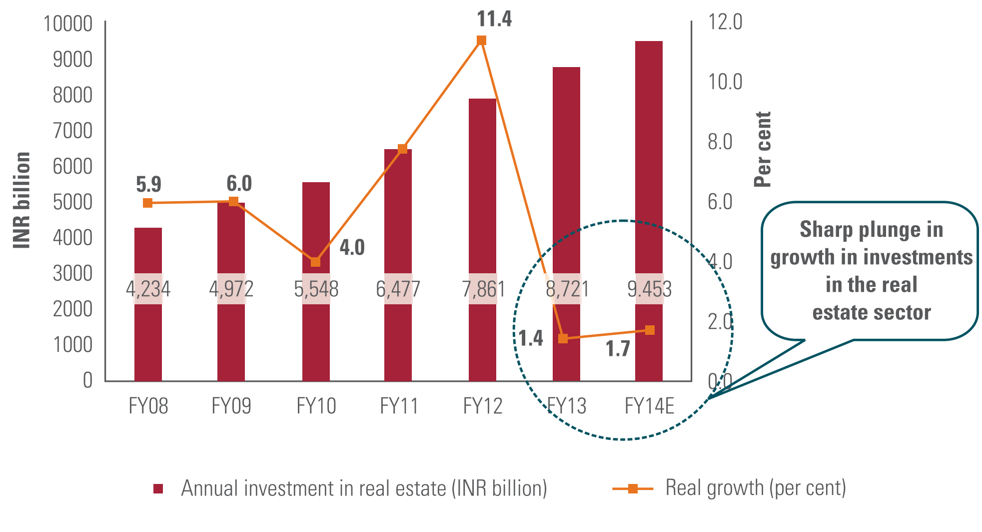
Sunil Mantri

President - National Real Estate Development Council

The funding mechanism in the real estate sector could require overhaul

Availability of adequate liquidity is an important input required for efficient development of the real estate sector. It is envisaged that over USD2 trillion needs to be invested to achieve the government's vision of 'housing for all by 2022'. To achieve this feat, an overhaul of the current funding mechanism will likely be required. The liquidity situation in India has become a grave challenge complicated by multiple factors. The large equity inflow witnessed between 2006 and 2008 has completely dried up, investments by households have peaked, and Government support continues to remain weak. Institutional lenders (banks and housing finance companies) have demonstrated a strong growth, but it has largely filled the gap created by the exit of low equity capital and low households' investment. Strong measures are urgently required to drive households' savings, opening up institutional lending and attracting equity capital, along with major structural reforms to drive the real estate sector and economic growth.

Annual investment in the real estate sector



Source: National Accounts Statistics 2014, MOSPI; KPMG in India analysis 2014

Investment in the real estate sector needs to grow at a CAGR of 18-20 per cent

India housing demand by 2022

Particulars	Urban (million units)	Rural (million units)	Total (million units)
Current shortage	19	40	59
Additional	28	23	51
Vacant houses	9	10	20
Core demand	37	53	90

Source: Census 2011; Report of the technical group on urban housing shortage (2012-17), Ministry of Housing and Urban Poverty Alleviation; Working Group on Rural Housing for XII Five Year Plan, Ministry of Rural Development; KPMG in India analysis 2014

India urban housing investment by 2022

Type of house	Target income group	% of housing need	Typical area (sq ft)	Number of houses (million)	Cost of house (INR million)	Total investment (INR billion)	Total investment (USD billion)
Social housing	EWS (1 BK)	40	Up to 300	18.4	0.5	31,280	521
LIG housing	LIG (1 BHK)	30	550-750	13.8	1.5-2.0	23,460	391
MIG	MIG (2-3 BHK)	20	800-1200	9.2	4.0-4.5	38,640	644
High end and luxury	HIG or rich class (above 2-3 BHK)	10	Above 1200	4.6	Above 5.0	46,000	767
Total				46.0		139,380	2,323

Source: Census 2011; Report of the technical group on urban housing shortage (2012-17), Ministry of Housing and Urban Poverty Alleviation; Working Group on Rural Housing for XII Five Year Plan, Ministry of Rural Development; KPMG in India analysis 2014

The government should focus on developing social rental housing, especially in the top two segments.

Additional investment:

Rural housing: USD100-150
Commercial real estate: USD500 billion
Urban infrastructure: USD1 trillion

About 0.9 million urban houses are lying vacant. The exact reason for their vacancy is not known.

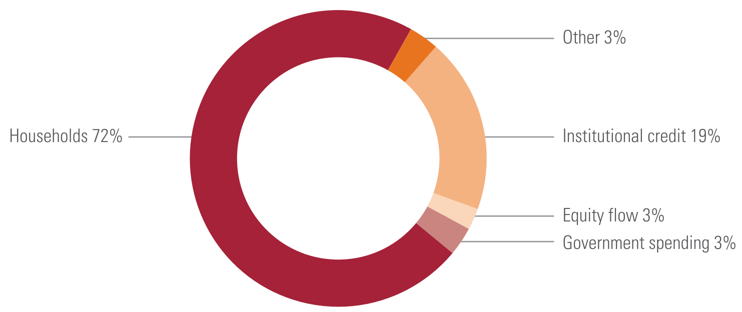
Opening up these houses could help reduce the quantum of new houses to be developed.

“With the launch of the ambitious ‘Housing for All’ and ‘Integrated City Infrastructure’ agenda, it is imperative to use all resources optimally and efficiently. Housing and Real Estate Finance, being the crucial resource, need a quantum jump multiplier, of USD2 trillion over the next eight years. This calls for all innovative options for resource mobilisation from all sources with appropriate incentives, leading to affordable and sustainable financial flows for the mammoth built environment sector needs.”

V Suresh,
Director, HIRCO Project Companies, Former CMD , HUDCO

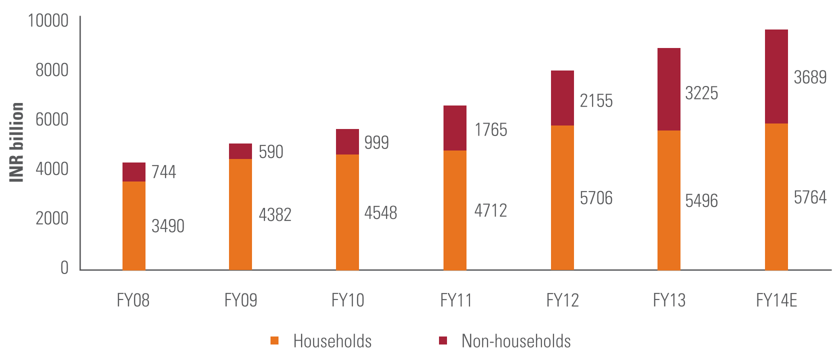
Weakening household investment is worrying

Break up of investment in real estate between FY08-14



Source: National Accounts Statistics 2014, MOSPI; Sectoral Deployment of Credit, RBI press release; Union Budget documents from FY08-14; Private Equity in real estate database, Venture Intelligence; Infrastructure Sector reports, BMI; Housing Finance Sector, CRISIL research; KPMG in India analysis 2014

Spending in the real estate sector by source



Source: National Accounts Statistics 2014, MOSPI; Sectoral Deployment of Credit, RBI press release; Union Budget documents from FY08-14; Private Equity in real estate database, Venture Intelligence; Infrastructure Sector reports, BMI; Housing Finance Sector, CRISIL research; KPMG in India analysis 2014

- Close to INR47 trillion (USD1 trillion) was invested in the real estate sector between FY08 and FY14
- Of this, about 72 per cent was met from households' savings
- Funding from Private Equity (PE) and capital markets, which contributed up to 10 per cent in the FY08 has accounted only for three to four per cent in the last few years
- Banks and Housing Finance Companies (HFCs) have demonstrated strong growth, but it has lagged the overall credit growth
- Lack of availability of long-term capital across the entire value chain of development, especially for land acquisition is a major reason for stagnant growth in private investment
- Government spending (Central and State) has been stagnant at three per cent of the total spending, most of which is in rural housing.

The current housing shortage in urban areas is estimated at 19 million units. Of this, about 95.6 per cent is estimated to be from Economically Weaker Sections (EWS) and Low Income Group (LIG) households, who cannot afford houses costing above INR15 lakh[1]. However, supported by the strong growth in household income in urban areas, it is expected that income growth may push a significant number of EWS and LIG households into a higher category. Thus, by the year 2022, majority of demand is expected to be from LIG and MIG segments of households, constituting 50 per cent of the total housing demand.

While, the total investment required for urban housing is about USD2.3 trillion, occupation of 9 million vacant houses could help reduce the housing need. If these houses are occupied, the total investment required would reduce to about USD2 trillion.

It is estimated that in the next eight years, India needs to invest more than INR125 trillion (USD2 trillion) at current prices to meet its housing needs, which is over INR16 trillion (USD260 billion) per annum. At the moment, about INR9.5 trillion (USD150 billion) is getting invested in the real estate sector annually, of which about 80 per cent or INR7.5 trillion (USD130 billion) is invested in housing development. Thus, investment in housing needs to be doubled, which can be achieved if investments are steadily increased by 12 to13 per cent per annum. Adjusting for inflation of about 6 per cent per annum against the government should target an effective increase of about 18 to 20 per cent per annum against 13 to14 per cent growth witnessed in the last six to seven years. More than 90 per cent of this investment is required in the development of urban housing, since rural housing (need of about 53 million affordable housing units) is estimated to require investment of only USD100-150 billion over the next eight years[2].

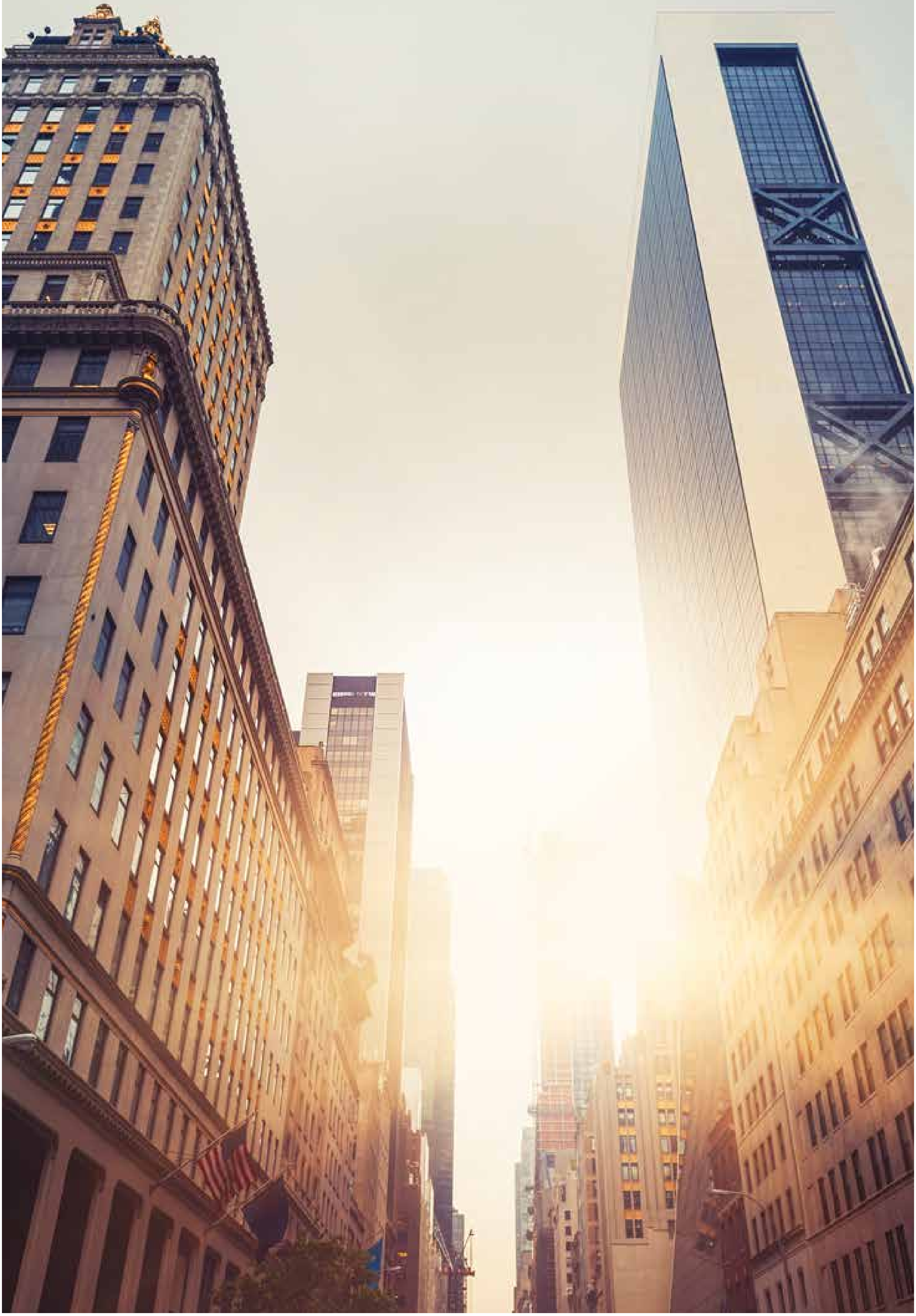
It must be noted that USD2 trillion is required only for housing development. This investment needs to be complemented by adequate investment in urban infrastructure (roads, sewerage, water etc.) and commercial real estate development (offices, retail malls, SEZs, etc). It is estimated that investment worth USD1 trillion is required between 2011 and 2030 to upgrade and develop suitable urban infrastructure and USD500 billion in commercial real estate development. Thus, the government should target a total investment of about USDthree to four trillion by the year 2022 to achieve its vision of 'Housing for all by 2022.'

Roadblocks in achieving the desired investment

As per KPMG observation, roadblocks which are posing a challenge to the healthy growth of the sector, and to achieving the desired level of investment, include:

- Weak financial markets limiting developers and institutional lenders to raise equity and debt capital
- Weak global and local economy restricting flow of equity capital
- Lack of institutional funding over long-term (the maximum tenure of any capital is about four to five years leading to multiple rounds of fund raising by developers)
- Lack of real estate dedicated financial instruments restricting flow of household and private savings in the real estate sector
- No formal lending sources available to developers to acquire land which accounts for about 20 to 40 per cent of a real estate project, and is as high as 60 per cent in Metropolitan and few Tier one cities
- Unfavourable regulations such as Rent Control Act deterring investment in the rental housing sector.

1. Planning Commission and KPMG in India analysis
2. KPMG in India analysis; MOSPI



Funding the vision

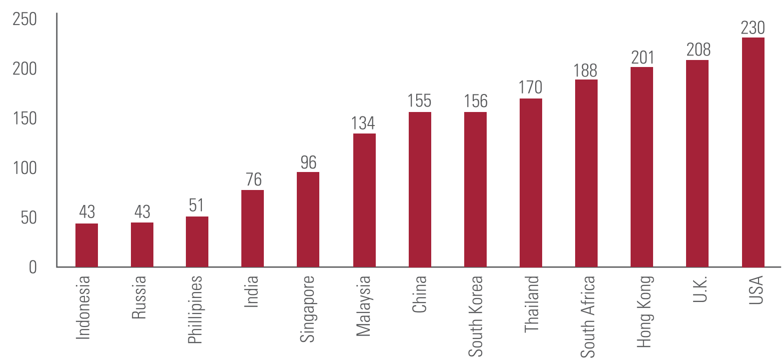
The government has less than a decade to achieve its vision of 'Housing for all by 2022' and it needs to act now to attract capital. With real estate cycle (from land acquisition to hand-over stage) spread over 7-8 years, reforms to increase capital flows are required now for any visible action over medium to long-term. Some suggestions in this light are detailed below.

- India lags behind its peers significantly to in financial sector credit to GDP
- It is only ahead of Indonesia, Russia, and Philippines
- In equity market capitalisation as well, India is way behind its peers
- India is ahead of China as a lot of Chinese equity capital is raised in Hong-Kong
- Developers have raised only USD3.2 billion from equity markets between FY08 and FY14, which is quite low compared to the investment required
- Fund raising from global markets such as Alternative Investment Market on the London Stock Exchange, and on Singapore Stock Exchange have not provided much success to developers due to expensive propositions.

Develop a sound financial market to attract higher capital

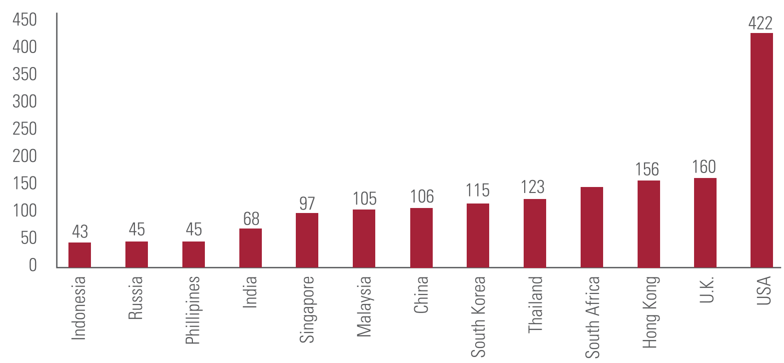
Direct institutional support to the real estate sector (banks, HFCs, private equity, etc.) accounts for only about 22 per cent of the total investment flow in the sector. As depicted below, India has low penetration of institutional funding of both mortgage debt and capital markets.

Domestic credit by financial sector to GDP (2012)



Source: Domestic credit by financial sector to GDP, World Bank Database, accessed August 2014; KPMG in India analysis 2014

Market capitalisation to GDP (2012)



Source: Market capitalization to GDP, World Bank Database, accessed August 2014; KPMG in India analysis 2014

In December 2012, the RBI allowed raising External Commercial Borrowings (ECBs) up to a maximum of USD1 billion for development of affordable housing. However, considering the large amount of investment required in the housing sector, and the inadequate financial sector, the ECB limit is low. It is suggested that instead of fixing the amount of investment, the RBI may fix a percentage of ECB at a project level. Further, the definition of affordable housing should be changed, and include MIG houses as well.

Provide long-term funding to developers

A real estate project has a lifecycle of about seven to eight years (from conceptualisation till handover), but many funding options a maturity period of four to five years. This often results in developers relying on informal private lending available at high cost, especially at the time of project conceptualisation or land acquisition. Land acquisition and approval stage account for about two to four years, and 20 to 40 per cent of the total project cost in urban peripheries, and is as high as 50 to 60 per cent in metropolitan and few tier-1 cities.

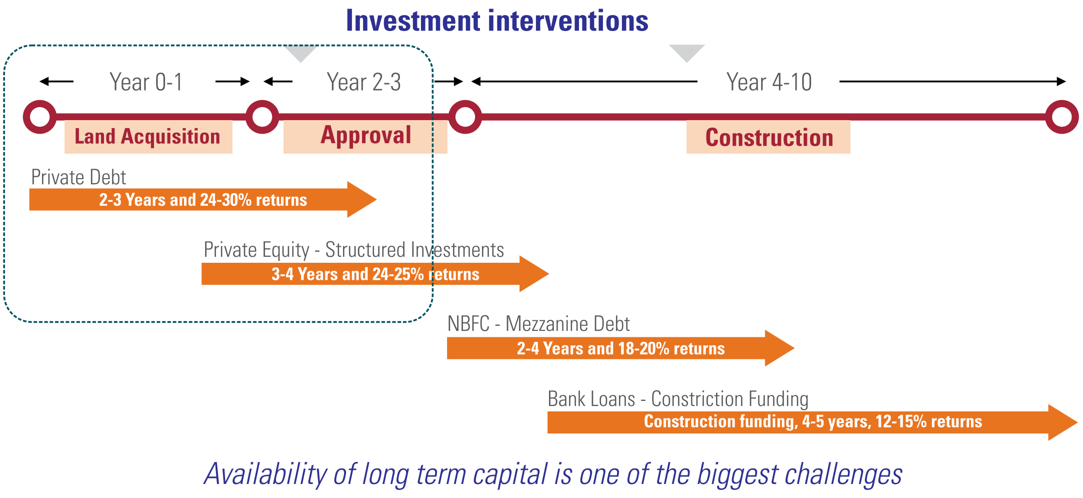
Investment at this stage is restricted due to Government/RBI regulations, which does not allow banks, HFCs, and foreign investors to fund land acquisition. Further, the high risk due to lack of clear land title and frequent delay in approval process also tend to restrict flow of capital from domestic private equity. Resultantly, the cost of funds at this stage is highest in the range of 24 to 30 per cent per annum. Developers have explored innovative options such as Joint Development, where they tie up with the land owner for developing the project. However, there are several taxation and commercial aspects which need to be carefully evaluated by developers before exercising this option.

"The project life-cycle of a housing project from land acquisition to handover has increased considerably in the last few years affecting affordable housing development. To accelerate development of housing, it is imperative that clearance mechanism is reformed and usage of new technology is encouraged by providing incentives.

Further, the RBI and the Finance Minister should raise action to do some hand-holding by giving one year rest to repay debt. This will help developers in addressing their financial situation and help in realizing the vision of housing for all by 2022."

Mr Navin Raheja,
Chairman NAREDCO and
CMD of Raheja Developers

Lack of formal funding channels at initial stages



Source: KPMG in India analysis 2014, NARDECO

KPMG perspective on Joint Development Arrangements – Target areas on the commercial and taxation front

As stated earlier in this report, Joint Development Agreement ('JDA') or Development Arrangement ('DA') are often resorted in the recent times by developers to ease funding requirement towards land acquisition, and to also share economic risk and rewards of the project with the land owner. The arrangements are structured in different manners to suit the requirements of both the parties, out of which common processes include area share arrangement, revenue share arrangement, or combination of the two coupled with some upfront deposit.

While entering into such JDA or DA, both the parties need to be cognisant of commercial, as well as taxation issues. Following are some commercials aspects that need consideration and negations between both the parties:

- Land valuation based on projects to be developed and expected returns
- Quantum of upfront deposit and terms of such deposit
- Sharing of economic risks and rewards
- Legal liabilities and responsibilities of development, as also recourse to the customers, etc.
- Roles and responsibilities of each of the parties, involvement of land owner in the project;
- Control and possession of land to be shared by both the parties;
- Entitlement of FSI to be received in future, if any;
- Right to mortgage land and raise finance;
- Marketing and branding of the project;
- Right to enter into sale agreement with third party customers;
- Demarcation of built-up area in the project.

Apart from the commercial aspects mentioned above, taxability of JDA/DA has been a subject matter of dispute between the taxpayer and the tax authorities. Plethora of judgments have been delivered on the subject, though specific facts, could lead to certain ambiguity if the arrangement is not structured properly, and not supported by appropriate documentation. Typical taxation issues that arise under JDA/DA arrangements are highlighted below:

Sr. No.	Particulars	Issues	Mitigation strategies
1	Point of taxability in the hands of the land owner; point of debate and negotiation as it could result into additional cash outflow for the developer	Whether transfer of land takes place in the hands of the land owner at the time of entering into JDA/DA with the developer, or at the time of handing over possession of the land to the developer, or at the time of sale of built-up area to third party customers, or at the time of executing conveyance deed. Further, the class of asset in the hands of the land owner (i.e. capital asset or stock-in-trade or capital asset converted into stock-in-trade) could have different point of taxability considering the provisions of the Income-tax Act, 1961 ('the Act').	Terms of documents to be executed like JDA/DA, Specific power of attorney or General power of attorney, etc. needs to be carefully deliberated and drafted to demonstrate when economic rights and possession in the land is handed over to the developer by the land owner. Further, strategy for conversion of land as stock-in trade needs to be properly planned and carefully evaluated.
2	Sale consideration in the hands of the land owner	If the point of taxability is determined at any stage before actual sale consideration is received by the land owner, whether the quantum of deemed sale consideration in the hands of land owner shall be cost of construction of the built up area to be received by the land owner or whether it should include margin of the developer or fair market value of land, whether the deeming fictions imputing stamp duty value provided in section 50C, or 43CA of the Act shall be applicable, etc. needs to be ascertain to compute taxable income for the land owner.	Keeping in mind the economic returns to be shared between both the parties, the documents for JDA/DA should be appropriately crafted to help ensure that the deeming fiction does not apply. Further, clause for deferral of consideration in the hands of the land owner could be considered without adversely impacting the right of the land owner, given the risks associated with the project.

Sr. No.	Particulars	Issues	Mitigation Strategies
3	Exposure to 'Association of Person' ('AOP')	Whether JDA between the land owner and the developer shall result in forming AOP between them, and whether AOP taxation shall trigger. Further, the AOP concept could be applied by service tax authorities as well.	Definite roles and responsibilities of each of the parties in the JDA agreements supported by documentary evidence demonstrating that each parties have performed their role and such role was important in the overall development of the project.
4	Service Tax Liability on entering into JDA/DA	The JDA/DA arrangement could attract service tax liability for the land owner as well as the developer (especially in the area sharing model). Further, when service tax liability gets triggered in the hands of the land owner on entering into JDA, then whether CENVAT credit shall be available to the land owner or not.	The clauses of JDA/DA, determines whether it is a sale transaction or a service transaction wherein development rights are provided by the land owner to the developer and hence, JDA/DA documents need to be drafted carefully.
5	Stamp Duty on execution of JDA/DA documents	Execution of JDA/DA documents could trigger stamp duty levy depending on the state in which the property is situated. The rates of duty is generally significant across the states.	The clauses of JDA/DA determines whether it is a transfer of immovable property or sale or transfer of rights and hence, JDA/DA documents need to be drafted carefully.

Source: KPMG in India analysis

In summary, though JDA/DA helps in addressing funding issue for the developer, the afore stated commercial and taxations aspects needs to appropriately evaluated, deliberated by both the parties, documented appropriately, and the entire arrangement effectuated following the spirit of the documents so executed. This will help in mitigating tax issues, and in also developing the project without any litigation.

Reform or amend the Rent Control Act to facilitate large scale development of rental housing stock

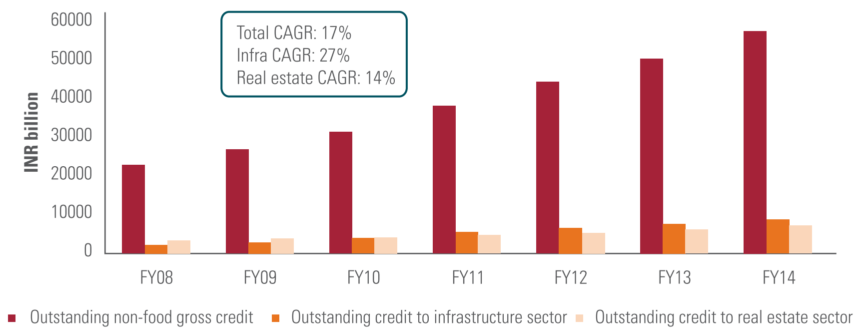
India has a low penetration of rental accommodation. According to census 2011, the rental housing stock in the country stands at 11 per cent of the total housing stock, which should ideally be in the range of 30 to 40 per cent. The ratio for India should be much higher as rapid urbanisation is seen to be resulting in the migration of significant number of youth population with little income to support house ownership. However, the existing Rent Control Act has often been cited as a roadblock in the development of large scale rental properties.

Country	Percentage of total housing stock*		Percentage of social housing stock by**	
	Social rental	Private rental	Pure public sector	Housing Associations (Limited profit/Non profit)
U.K.	20	10	54	46
Ireland	7	11	90	10
USA	3	29	31	69^
Australia	5	22	85	8
Canada	6	28	34	66
Austria	23	17	43	53
France	16	24	Some	90^
The Netherlands	35	12	1	99
Denmark	19	18		100^

Source: International experience in providing affordable housing, IDFC 2011
Note: Housing associations are for-profit, non-profit or limited profit organisations that build and/or manage low-cost or social housing. * Remainder of total housing stock is predominately ownership
** The social housing stock includes both social rental and ownership units
^ Include some for-profit associations, co-operatives, moderate rent agencies and regulated private landlords. Some associations have tenant shareholders

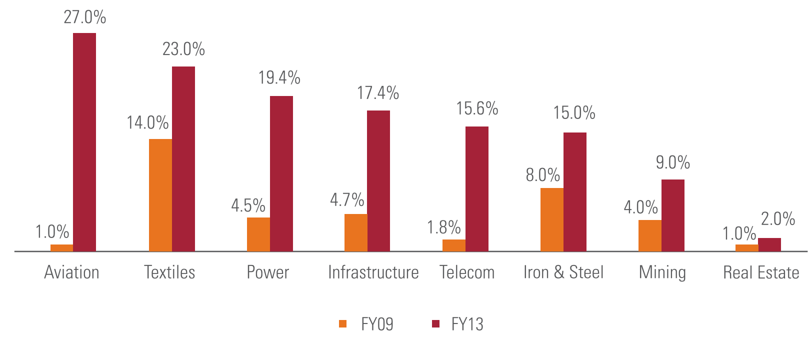
Readying banks and HFCs

Banks sectoral deployment of credit



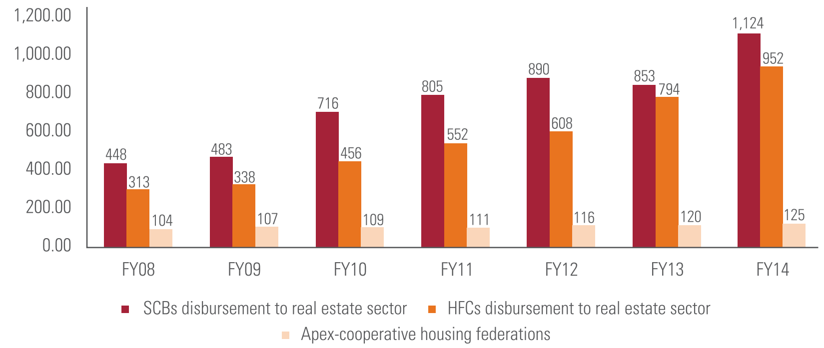
Source: Sectoral Deployment of Credit; RBI press release

Sector-wise stressed assets



Source: Growing NPAs in banks, Assocham

Banks and HFCs disbursement in the RE sector (INR billion)



Source: Annual Report FY08-FY13, National Housing Bank; Sectoral Deployment of Credit, RBI press release; KPMG in India analysis 2014

- The real estate sector can be compared with the infrastructure sector as both have similar civil construction component and project lifecycle.
- The credit to real estate sector has increased at half the rate of the infrastructure sector in the last seven years.
- However, stressed assets in the infrastructure sector have risen sharply in the last few years due to structural issues
- Meanwhile, stressed assets in the real estate have one of the lowest restructured assets representing strong fundamentals.
- Institutional lending has nearly tripled in the last seven years filling the liquidity gap created by equity capital and households' savings
- Lending to developers has declined from about 40 per cent in FY08 to 25 per cent in FY14.

"The realization of the vision of 'homes for all by 2022' requires conducive macro-economic environment, proper land acquisition, infrastructural planning, effective delivery mechanisms, appropriate funding sources, synchronised action by various stakeholders, viz., private developers, government representatives and the finance community together with judicious micromanagement. These factors would help to achieve global benchmarks in terms of investment, development and joint ventures. Since the housing sector provides a relatively safe recourse for bank credit because of the lower default rate, banks must continue to stress this as a focal lending area".

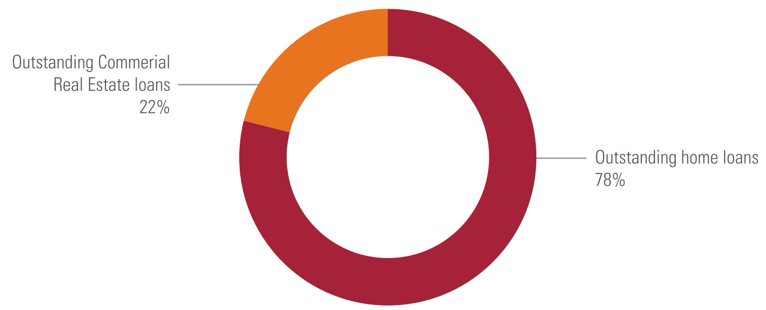
Mr R.K. Dubey,
CMD of Canara Bank

Banking and NBFC sectors have provided the much needed respite to the real estate sector by replacing the fall in domestic and foreign equity capital and slowdown in households' investment. However, several restrictions were imposed on banks by the RBI to limit their rising exposure to the sector citing high risk, especially in the light of subprime crisis in United States of America which led to the Global Financial Crisis in 2009.

This has limited the credit growth in the real estate sector; as the CAGR of banks outstanding credit to real estate sector has been only 14 per cent in contrast to 17 per cent for non-food gross credit and 27 per cent to the infrastructure sector. However, stressed assets or restructured assets or non-performing-assets (NPAs) in the real estate sector have been among the lowest. The stressed assets in the real estate sector are in the range of 1-2 per cent for most banks and HFCs, which is much better than overall stressed assets of banks, and especially the infrastructure sector which has large stressed assets, resulting due to structural issues leading to significant cost and schedule overrun. Given the past experience, it is imperative that RBI relaxes the restriction imposed on lending to the real estate sector and facilitate higher flow of capital in the sector.

Another trend being observed in funding by banks and HFCs lend mostly to home buyers, than developers. Exposure to real estate developers is limited and needs to be enhanced. In the recent policy, the RBI has allowed banks to raise long-term funds to finance housing loans for affordable houses. However, the RBI has not allowed banks to extend these loans to developers.

Banks real estate lending by borrower

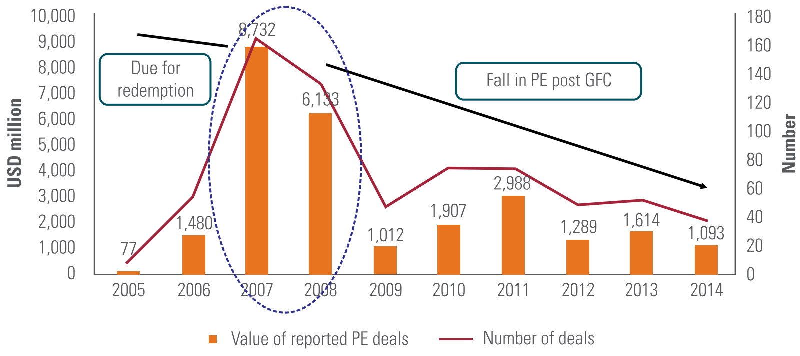


Source: Sectoral deployment of credit, RBI press release

The RBI must also work on improving credit access via EWS and LIG sections of the society. These sections face the issue of accessing credit due to weak knowledge of such facility, inadequate documentation to support income, and lack of guarantees. The RBI needs to strengthen micro-finance penetration in the sector and help improve credit access.

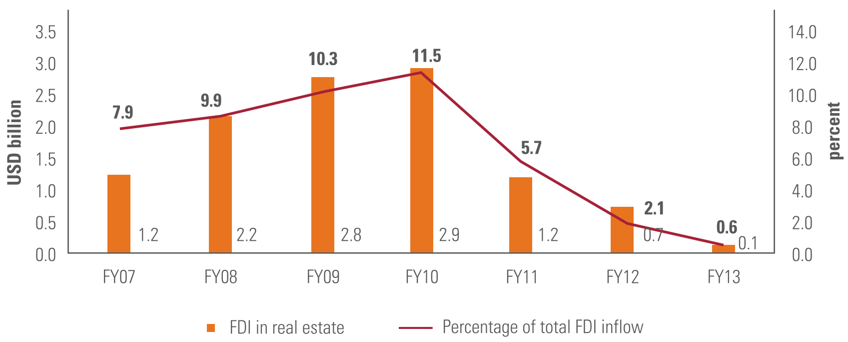
Attract higher equity flow

Number and value of the reported PE deals



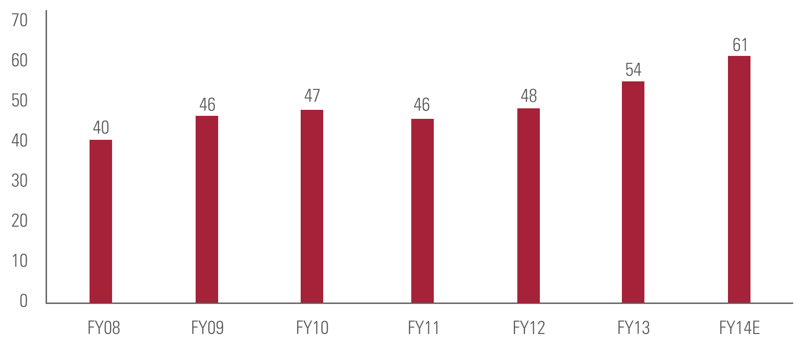
Source: Private equity in real estate database, Venture Intelligence; KPMG in India analysis 2014

FDI in the Indian real estate



Source: FDI Statistics, Department of Industrial Policy & Promotion, accessed August 2014; KPMG in India analysis 2014

Exchange rate INR/USD



Source: Foreign Exchange Rate, RBI, accessed August 2014 2014

- Private equity investment has touched a new low since its launch
- Weak global and domestic economy, wide currency fluctuations and restrictive FDI policies are main reasons
- Flow of foreign capital has almost dried up. Although, some revival is being witnessed due to recent measures taken by the Government

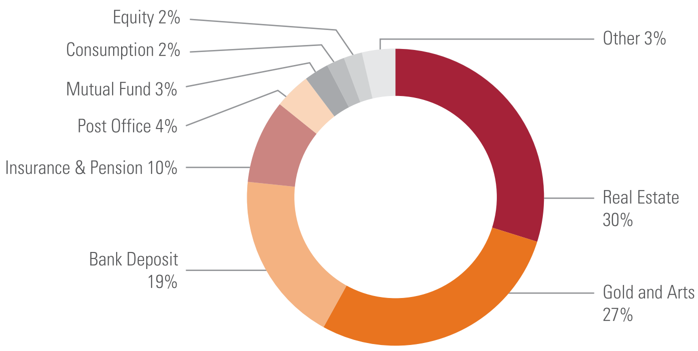
Lack of funding options from banks and HFCs have led to developers to seek funding from PE investors and capital markets. After receiving a good initial response, the equity funding almost dried after the financial crisis in 2008. PE and capital market funding, which accounted for about 10 per cent of total investment in real estate in FY08, fell to about two to three per cent post the crisis. Further, the PE investment which came in 2007 to 2008 period is due for redemption now, creating additional pressure on liquidity in the sector

Since FY07, total foreign equity inflow in the real estate sector accounted for only 5 per cent of the total Foreign Direct Investment (FDI) inflow in India. A majority of this flow came before the financial crisis. Road-blocks such as the old FDI policy, structural issues such as high gestation period, extreme fluctuation in currency, lack of Real Estate Investment Trusts (REITs) market, and the global economic slowdown resulted in drying up foreign capital. The recent changes in the Union Budget with respect to FDI policy and REITs are expected to boost flow of foreign capital again in India albeit gradually. However, some flexibility with respect to taxation in the current REITs policy are required to make them a success story.

Another issue restricting investment, especially from foreign investors, is huge fluctuation in the currency. The INR has depreciated 50 per cent in last 6 years to INR60/USD. A stable currency is pre-requisite for consistent flow in foreign capital.

Channelizing higher household savings

Segmentation of savings by Urban Households in India



Source: Assessing the economic impact of India's real estate sector, CBRE and CREDAI

- Households in India have huge real estate appetite
- However, high investment ticket size restrict flow of capital in the sector
- Instead, households prefer to invest in other physical assets especially Gold, which strains government forex reserves
- Financial instruments targeting investment in the real estate sector should be developed to channelize higher flow of household savings
- Tax incentives should be increased and allowed for investment in under-construction properties as well.

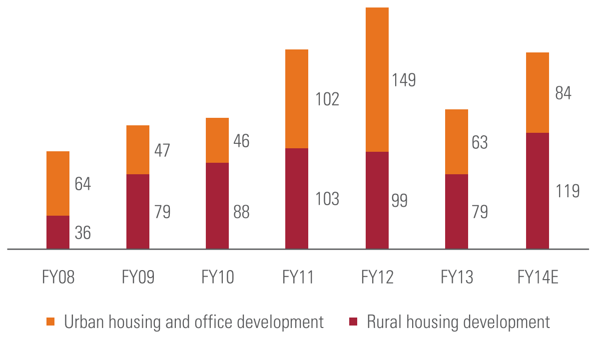
Indian households have huge fondness for real estate and precious metal. This is evident from the fact that nearly 60 per cent of household savings are in physical assets. Of the total savings, about 30 per cent are flowing in the real estate sector, and rest 30 per cent is flowing in other physical assets such as gold. Since investment in physical real estate is high ticket investment, many households are unable to invest in real estate and to augment participation of household in the real estate sector, special financial instruments for the real estate sector shoud be developed to help channelize higher flow. It could also help reduce investment in precious metals, many of which flows out of the country affecting the forex reserve.

REITs is a good example of a financial instrument channelising households' saving in physical assets. However, REITs are allowed to invest in assets which have existing rental yield. They do not facilitate development of new assets. As 70 per cent of India's built environment needs to be developed, innovative financial instruments are required to channelize higher investment in the construction of assets instead of built-up properties. One such mechanism could be setting up of long-term housing bonds with maturity of at least 10 years for investment in housing development. Further, rental housing sector should be reformed as discussed above, and given a commercial real estate tag to facilitate flow of capital from REIT funds and other private sources.

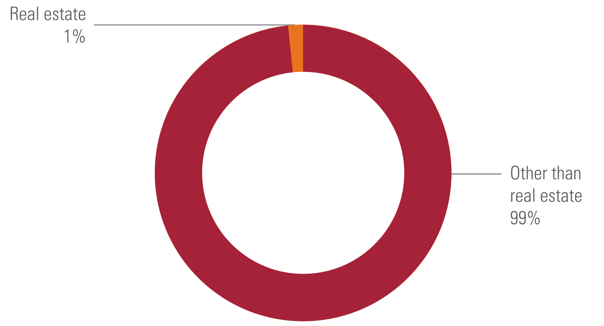
Additionally, further tax incentives may be provided to households to attract households' savings. The tax breaks provided in the recent Union Budget 2014 to 2015 are expected to augment households' investment in the real estate sector by USD2-3 billion. The current tax incentives are present only if an individual invests in ready-to-move-in properties making investment in under-construction residential and non-residential properties unattractive. Some large tax incentives are required especially to make new residential and non-residential construction a striking proposition for households.

Government should increase its participation

Central government spending on housing and office development (INR billion)

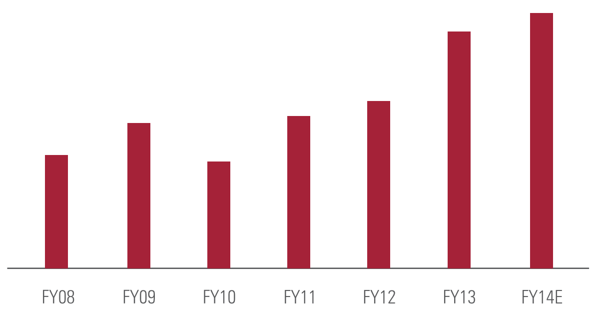


Break up of central government expenditure between FY08 and FY14

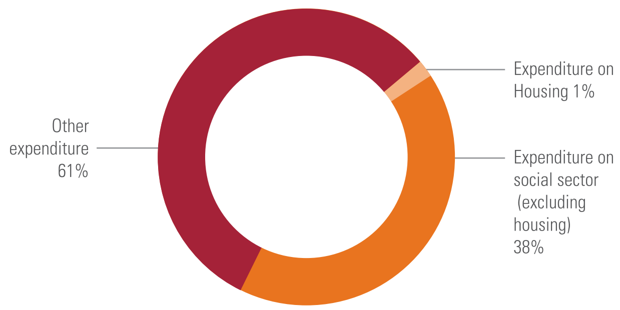


Source: Union Budget documents of Central Government between FY08 and FY14; KPMG in India analysis
*includes expenditure by MoUD, MoHUPA and Ministry of Rural Development

State governments spending on housing (INR billion)



Break up of State expenditure between FY08 and FY14



Source: State Finances, RBI; KPMG in India analysis 2014

List of indirect taxes imposed on real estate development

S.no	Tax	Percentage of property cost
1	Developer agreement stamp duty	5
2	Stamp duty on purchase of property	5
3	Registration	1
4	Value added tax	1
5	Service tax	2.6
6	VAT to contractor	4
7	Other levies such as service tax	2.6
8	Excise and custom duty	15
	Total	~35

Source: KPMG in India analysis; NAREDCO

Huge taxes; lengthy approval process; unavailability of urban land at affordable rates, makes housing development, especially affordable housing development, a challenging proposal for private developers.

The government must intervene and address these challenges

The Government, both Central and State, participation in the real estate sector is currently inadequate. Despite being a major source of revenue (through direct and indirect taxes), the amount spent on the real estate sector is not adequate. NAREDCO has estimated that about 35-40 per cent of housing cost comprises of various indirect taxes, but the budgetary support it receives from government is only in the form of tax incentives and allocation towards housing development. Rationalizing these taxes could help reduce housing cost and enable higher flow of investment.

It is also suggested that the government increases its allocation to the sector, and facilitate development of affordable houses. It is estimated that only 30,000-35,000 hectare of land is required to meet the housing need of the country over the next eight years. This can be achieved by unlocking huge land parcels available with various government agencies, urban local bodies, and public-sector corporate.

Further, the government should work towards streamlining the approval mechanism, which currently takes about two to three years. As per the World Bank Doing Business Report 2013, India ranks 182 in the ranking of 185 countries on the ease of dealing with construction permits. On an average, 34 procedures over a period of 196 days are needed for obtaining construction permits vis-à-vis 14 approvals over an average of 150 days in the OECD region, and 16 approvals over an average of 222 days in the South Asia region. By reducing this time-frame, the churn of capital in the sector could increase substantially.

"To facilitate credit growth in the real estate sector, the transparency in real estate development must be improved. Several structural issues such as lengthy approval process; construction delays; unclear land titles; restructuring of commercial real estate loans, etc. must be addressed to improve lending growth."

Mr B. Sriram,
Managing Director and GE (NB), State Bank of India

Conclusion

India has a significant housing deficit, as almost a fifth of urban and rural households have access to limited housing facilities. To achieve the vision of 'Housing for all by 2022', it is estimated that India needs to develop houses at the rate of 30,000-35,000 units per day for the next 8 years (about nine crore houses including six crore of existing shortage). A majority of these houses need to be in the affordable segment requiring investment of more than USD2 trillion.

The challenge is significant but not impossible, if this objective is supported by right policy mix, especially to improve institutional investment in the sector. The government has announced new policy decisions in the recent Union Budget 2014-15, however, large scale development of affordable housing projects is still a challenging proposition for many private developers.

Over dependence on personal savings and informal lending practices in the Indian real estate sector requires major intervention by the Government and RBI. Strong financial and banking system allowing raising of long-term debt and equity, allocating higher funds towards real estate sector by banks, and developing Public-Private-Partnership models in the sector are few requirements to boost the investments in the sector. In addition to improving liquidity, certain other road-blocks such as unavailability of low-cost land, lack of proper urban infrastructure, and connectivity with urban peripheries, stringent approval process, ambiguity in several direct and indirect tax provisions, and archaic rental laws, require urgent attention from the government to help convert this vision into reality.

A summary of our recommendations agency-wise are provided below:

4.1.2.1 Government

- Grant infrastructure status to the real estate sector
- Provide direct support to private developers or include them in the government's housing programme
- Promote PPP in the real estate sector by releasing land parcels for housing development
- Streamline the approval mechanism to help reduce cost and schedule overruns in real estate projects
- Set-up long-term funding mechanisms such as the National Housing Bond, or allocate certain percentage from large funds such as insurance, pension or provident funds towards housing development
- Address the various tax and non-tax issue in the Joint Development model
- Popularise housing loans further by increasing tax incentives to individuals
- Regularly release important housing data such as housing start and completion to analyze housing sector progress.

4.1.2.2 RBI and HFCs

- Increase tenure of home loans from the current 20 years to about 30 years to improve affordability
- Tie up with developers to extend long-term funding and reduce project risk
- Improve the credit appraisal mechanism for both households and developers to reduce defaults
- Educate households (especially LIG and EWS households) about credit facilities, and the ways to utilise them
- Increase allocation towards the real estate sector
- Open up ECB in the real estate sector.

About KPMG in India

KPMG in India, a professional services firm, is the Indian member firm of KPMG International and was established in September 1993. Our professionals leverage the global network of firms, providing detailed knowledge of local laws, regulations, markets and competition. KPMG in India provide services to over 4,500 international and national clients, in India. KPMG has offices across India in Delhi, Chandigarh, Ahmedabad, Mumbai, Pune, Chennai, Bengaluru, Kochi, Hyderabad and Kolkata. The Indian firm has access to more than 7,000 Indian and expatriate professionals, many of whom are internationally trained. We strive to provide rapid, performance-based, industry-focussed and technology-enabled services, which reflect a shared knowledge of global and local industries and our experience of the Indian business environment.

KPMG International

KPMG International is a global network of firms providing Audit, Tax and Advisory services. KPMG member firms operate in 155 countries, and have 155,000 people working in member firms around the world.

The KPMG Audit practice endeavours to provide robust and risk-based audit services that address member firms' clients' strategic priorities and business processes.

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KPMG Advisory professionals provide advice and assistance to help enable companies, intermediaries and public sector bodies to mitigate risk, improve performance, and create value. KPMG firms provide a wide range of Risk Consulting, Management Consulting and Transactions & Restructuring services that can help their clients respond to immediate needs as well as put in place the strategies for the longer term.

About NARDECO

National Real Estate Development Council (NAREDCO) formed under the aegis of the Ministry of Housing & Urban Poverty Alleviation (MHUPA), Government of India, in 1998, was established as an autonomous self-regulatory apex national body.

NAREDCO was formed with a mandate to induce transparency and ethics in real estate business, and transform the unorganised Indian real estate industry into a mature, professional, and globally competitive industry.

NAREDCO strives to be the leading advocate for developing standards for efficient, effective, and ethical real estate business practices, valued by the stakeholders and viewed crucial for success in India.

The council, that is the collective voice of real estate in India, was founded by leading public and private sector companies.

NAREDCO connects closely with various authorities, Government, Public and private, in addressing real estate issues. It is worth noting that presently, Dr. Girija Vyas, Honourable Minister of Housing and Urban Poverty Alleviation; Government of India, is its Chief Patron, who participates in various interactions with NAREDCO members. Public institutions like Housing and Urban Development Corporation (HUDCO), National Housing Bank (NHB), Delhi Development Authority (DDA), Building Material and Technology Promotion Council (BMTPC) and Hindustan Prefab Ltd., LIC Housing, and HDFC are the governing council members of NAREDCO.

NAREDCO has played a key role in formulating government policies and budgets at the level of central and state governments, besides addressing issues related to developers. Policies on affordable housing, fast tracking project approvals, regulation & development Bill, and Model Rental Control Act are some of the achievements of the association in the near past. The government gives due weightage and respects suggestions put forth by the NAREDCO, which in itself is its strength.

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